Consumer Driven Health Accounts Summary[i]
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Several options exist for employers to provide accounts that employees can use to pay for health care expenses not otherwise covered by a health plan; the options vary as to tax treatment, who can contribute, and what expenses can be covered.

There are four types of accounts that have received recent attention which can be used to help fund employee health care expenses:

- Flexible Spending Accounts (FSA)
- Medical Savings Accounts (MSA)
- Health Reimbursement Arrangements (HRA)
- Health Savings Accounts (HSA).

Flexible Spending Accounts (FSA)

Health care flexible spending accounts are employer-established benefit plans that reimburse employees for specified medical expenses as they are incurred. These accounts are allowed under section 125 of the Internal Revenue Code and are also referred to as "cafeteria plans" or "125 plans." Authorized by the Revenue Act of 1978, Flexible Spending Accounts became available January 1, 1979.

The employee contributes funds to the account through a salary reduction agreement and is able to withdraw the funds set aside to pay for medical bills. The salary reduction agreement means that any funds set aside in a flexible spending account escape both income tax and Social Security tax. Employers may contribute to these accounts as well.

There is no statutory limit on the amount of money that can be contributed to health care flexible spending accounts. However, some companies place a limit of $2,000 to $3,000 on flexible spending accounts. Once the amount of contribution has been designated during the open enrollment period that occurs once each year, the employee is not allowed to change the amount or drop out of the plan during the year unless he or she experiences a change of family status. By law, the employee forfeits any unspent funds in the account at the end of the year. There have been proposals introduced in Congress to ease this "use it or lose it" rule by allowing up to $500 to be carried over to the next year; such proposals have not been enacted.

Funds can be used for un-reimbursed medical expenses as defined by Internal Revenue Code section 213 such as health care deductibles, co-payments, eligible non-prescription medications, and other items not covered by insurance. This excludes premiums for health insurance coverage and long-term care expenses.

Medical Savings Accounts (MSA)

Medical savings accounts are savings accounts used to pay for un-reimbursed health care expenses. These accounts can accumulate tax-deferred interest similar to individual retirement accounts (IRAs). Authorized by Title III of the Health Insurance Portability and Accountability Act of 1996, medical savings accounts became available January 1, 1997.

Funds are controlled and owned by the account holder. The employee or the employer--never both--makes contributions. In order to qualify, the employee must be covered by a high-deductible health insurance plan and must be self-employed or employed by a firm with 50 or fewer employees.

The maximum contribution to a medical savings account for single coverage is 65 percent of the deductible on the employee's health plan and 75 percent of the deductible for family coverage. For example, if an employee has a health plan with a deductible of $2,225, then he is allowed to contribute a maximum of $1,446.25 to a medical savings account for single coverage. With a family plan deductible of $4,500, a maximum contribution of $3,375 is allowed.

Savings are rolled over every year and are portable, regardless of employment status. Funds can accumulate earnings, which are not taxed unless funds are withdrawn for non-medical expenses.

Funds can be used on a pretax basis to pay for un-reimbursed medical care expenses as defined by Internal Revenue Code section 213, long-term care insurance premiums, health insurance premiums paid while unemployed, and COBRA premiums (for continuation of health insurance coverage available to formerly covered individuals under provisions of the Consolidated Omnibus Budget Reconciliation Act).

If withdrawn for non-medical purposes, savings are considered taxable income and are subject to income taxes in addition to a percent penalty tax. If the employee becomes disabled or reaches Medicare eligibility age, however, distributions for non-medical expenses from the account are subject only to ordinary income tax, not the penalty tax.

Health Reimbursement Arrangements (HRA)

Health reimbursement arrangements, also known as "health reimbursement accounts" or "personal care accounts," are a type of health insurance plan that reimburses employees for qualified medical expenses. The U.S. Department of the Treasury issued guidance on health reimbursement accounts in a revenue ruling in June 2002. Because these plans are just emerging, their designs are still evolving. Health Reimbursement Arrangements became available on June 26, 2002.

Health reimbursement arrangements are open to employees of companies of all sizes, unlike medical savings accounts that are only available for small business employees. A health reimbursement account provides "first-dollar" medical coverage until funds are exhausted. For example, if an employee has a $500 qualifying medical expense, then the full amount will be covered by the health reimbursement arrangement if the funds are available in the account.

Health reimbursement accounts consist of funds set aside by employers to reimburse employees for qualified medical expenses, just as an insurance plan will reimburse covered individuals for the cost of services incurred. The guidance provided by the Department of the Treasury makes it clear that health reimbursement accounts are not a new type of account designated within the Internal Revenue Code. Rather, employers qualify for preferential tax treatment of funds placed in a health reimbursement account in the same way that they qualify for tax advantages by funding an insurance plan. (Employers can deduct the cost of an insurance plan -- and now a health reimbursement account -- as a business expense under Internal Revenue Code section 162.)

Under a health reimbursement account, the employer provides funds, not the employee. All unused funds are rolled over at the end of the year. Former employees, including retirees, can have continued access to unused reimbursement amounts. Health reimbursement accounts remain with the originating employer and do not follow an employee to new employment.

Health Savings Accounts (HSA)

Health Savings Accounts are tax-exempt trust or custodial accounts established exclusively for the purpose of paying or reimbursing qualified medical expenses. These accounts can accumulate tax-deferred interest similar to individual retirement accounts (IRAs). Authorized by the Medicare Prescription Drug Improvement and Modernization Act of 2003, medical savings accounts became available on January 1, 2004.

Health Savings Accounts are available to individuals who enroll in an high-deductible health insurance plan (HDHP), are not Medicare enrolled, are not covered by another health plan that is not an HDHP, and may not claimed as a dependent on another persons tax return.

Funds are controlled and owned by the account holder. The employee or the employer makes contributions. Savings are rolled over every year and are portable, regardless of employment status. Upon death, any remaining balance in the HSA becomes the property of the individual named in the HSA instrument as the beneficiary of the account.

Funds can accumulate earnings, which are not taxed unless funds are withdrawn for non-medical expenses. If withdrawn for non-medical purposes, savings are considered taxable income and are subject to income taxes in addition to a penalty tax. If the employee becomes disabled or reaches Medicare eligibility age, however, distributions for non-medical expenses from the account are subject only to ordinary income tax, not the penalty tax.

The maximum annual contribution to a HSA is the sum of the limits determined separated for each month, based on status, eligibility and health plan coverage as of the first day of the month. For calendar year 2004, the maximum monthly contribution for eligible individuals with self-only coverage under an HDHP is 1/12 of the lesser of the annual deductible under the HDHP (minimum of $1000) but not more than $2600. For eligible individuals with family coverage under an HDHP, the maximum monthly contribution is 1/12of the less of the annual deductible under the HDHP (minimum of $2000) but not more than $5150.

Funds can be used on a pretax basis to pay for qualified long-term care insurance premiums, health insurance premiums paid while unemployed, and COBRA premiums (for continuation of health insurance coverage available to formerly covered individuals under provisions of the Consolidated Omnibus Budget Reconciliation Act). In addition, for individuals over age 65, premiums for Medicare Part A or B, Medicare HMO, and the employee share of premiums for employer-sponsored health insurance, including premiums for employer sponsored retiree health insurance, can be paid from an HSA. Premiums for Medigap policies are not qualified medical expenses.

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[i] Adapted from Health Spending Accounts by Haneefa T. Saleem, http://www.bls.gov/opub/cwc/print/cm20031022ar01p1.htm, Viewed 1/25/04